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The Welfare State in Transition Economies and Accession to the EU

HANS-JÜRGEN WAGENER

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HANS-JÜRGEN WAGENER

Frankfurt Institute for Transformation Studies
European University Viadrina Frankfurt (Oder)

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1. Introduction[1]

Eastern enlargement of the European Union will create a new, the south-eastern, periphery of the Union, a periphery which is partly situated close to the economic core. It has been shown (by Fischer, Sahay, Vegh 1998) that distance from the core, be it Brussels or Düsseldorf, is a factor strongly influencing economic convergence as it happened in Western Europe after World War II. Under normal conditions, countries like Czechoslovakia, Slovenia, and, of course, Eastern Germany should be on a productivity level comparable to Western Germany, Austria, Italy, countries like Poland and Hungary on a level perhaps comparable to Spain. Such was the situation immediately before and after the war (Wagener 1999a). However, conditions in Eastern Europe were not normal - the region came under the hegemony of the Soviet Union and it was forced to adopt the Soviet political and economic system. So it did not take part in the impetuous convergence process that has characterized economic development of Western Europe for the last 50 years. The present productivity level is at best 50 per cent of what it could have been. Eastern Europe moved away from Europe and Eastern Central Europe from the core of it. Peripherisation is the result of 50 years of communism.

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After the collapse of Soviet hegemony and of the Soviet-type system, the countries of Eastern Central Europe (ECE) immediately declared their intent to "return to Europe" which means above all catching up with the post-war political and economic development. A central feature of the European economic and political system is the welfare state. Despite of a great diversity in its institutional arrangements, there is a common commitment and there are shared values which allow to speak of a European welfare state clearly to be distinguished from the Anglo-American and Japanese social cultures. With the abolition of the market and private striving for profit as driving forces of the economic system, the Soviet-type economy made social policy pointless - there was not any more an autonomous economic sphere whose working and results are to be regulated, complemented, or changed by political power. Hence, the communist welfare state, if there is such a thing (for let it be clear: a high share of education and health services in final demand and an income distribution in favour of the non-active or poorer parts of the population do not make in themselves a welfare state), must be something completely different from the European welfare state even if social justice, one of the shared values within the latter, was also one of the catch words of communism.

Return to Europe poses a double task for those who endeavour the journey: the transformation of the political and economic system and the catching up of productivity levels. Both are not independent of each other. For as the theory of conditional convergence (Barro, Sala-i-Martin 1992) suggests, convergence clubs are defined by their systemic properties. It is not undisputed, we have to admit, whether the European welfare state belongs to these essential properties. So it may be assumed that on their way back to Europe the countries of ECE have more degrees of freedom in this respect than in others where there is theoretical consensus and a well defined *aquis communautaire*.

Seen from the side of the incumbent members of the European Union, return to Europe of the ECE countries is treated as eastern enlargement of the Union, the most comprehensive enlargement project since 1973 when the United Kingdom, Ireland, and Denmark joined the Europe of the Six. At that time basic conditions for accession have been formulated which, for the present case of eastern enlargement, have been re-stated at the Copenhagen summit. Next to the general conditions of democratic rule of law and a functioning market order, it is the *aquis communautaire* which erects the highest hurdle before the entrance to the Union. The Copenhagen conditions also mentioned competitiveness: the accession candidates should be able to put up with competition from the Union and the Union should not suffer unduly from competition from the acceding countries.

It is generally thought that these conditions pose little problem in the context of social security. While the Economic and Monetary Union (EMU) is a highly developed part of the *acquis* (not in all its elements obligatory as membership of the Euro-bloc shows), the European Union is not yet a social union and will not be so for the foreseeable future. Convergence of social conditions will be the outcome of economic convergence, it cannot be a precondition. Hence candidate countries are free to choose welfare regimes which they think appropriate for their stage of development and their social culture. Some advisers recommend, and some critics fear, that ECE countries should orient themselves towards American flexibility and low key welfare provisions becoming thus model cases of growth and efficiency, or Trojan horses of the race to the bottom of welfare.

Even if the social *acquis* is not very comprehensive, however, it is not an empty set. It can be ascertained on four levels:

- the level of the single market with health and safety prescriptions,
- the level of the social protocol which has been incorporated in the Treaty of Amsterdam with working time and equal opportunity regulations for instance,
- the level of social dialogue rules demanding social partnership e.g.,
- and the level of what is called the "soft *aquis*", i.e. some kind of European social culture that cannot be made binding for any candidate country, but which it is expected to share.

It is obvious that some of the elements of the social *aquis* imply costly investments on the side of the less developed candidate countries. On the other side, competition by low wage and low social cost labour is a point of concern in some incumbent member states.

On the following pages I will attempt to assess the measures taken to transform the social security system in the post-communist countries of ECE. The guiding question should be whether by enlarging the European Union into this direction, the *aquis* in its broader meaning, not as a body of legal regulations, but as an economic and social culture, comes under a threat. In the next chapter a brief survey of the starting conditions, the communist welfare state, is given. Transformation of the social security system can be divided into two phases which will be discussed in chapters 3 and 4. Some considerations follow about harmonisation conditions of access. The essay ends with a short conclusion.

2. The Socialist Welfare State

It has become common to start reflections on the post-socialist welfare state with Kornai's (1995: 131) dictum that the Hungarian and, implicitly, the socialist welfare state in general was born "prematurely", i.e. the countries of Eastern Europe introduced lavish welfare measures without the necessary economic basis or a corresponding high level of GNP. This statement is in contrast to the received pre-1989 opinion that the socialist welfare state, as far as size and scope are concerned, is very much in line with western developments which could be taken as confirmation of the at that time popular convergence hypothesis (Pryor 1968, Castles 1986, and also Götting 1998: 77-80). Such inter-system comparisons suffer from several shortcomings: GNP comparisons are on a very shaky basis because of price and quality problems, and the organisation of the welfare state is so different that quantitative evaluation is almost impossible. A second remark with respect to Kornai's dictum refers to the fact that development is not the only determinant of welfare state size. Ideology, or shared opinions and values, is a second factor to the effect that also in the West continental ideas about social security differ from anglo-american ones. And ECE, already before the communist takeover, shared the continental tradition. Even on the European continent we find different levels of welfare provision. The latecomers to social security, Sweden and The Netherlands e.g., have much more comprehensive systems than, say, Germany and Austria. Also in the East commitment to social security and equality differed in the pre-communist as well as in the communist period, Czechoslovakia cared more for both than Poland for instance.

Be that as it may. If not lavish - there was nothing lavish under communism, even not the fringe benefits of its ruling class - the socialist welfare state was comprehensive and sizeable. However, it was a worker's privilege, not a citizen's right. In daily life the difference was minimal, since almost everybody was a worker. Those who were not, but were working people, got incorporated into the socialist welfare state rather lately and under special conditions: *kolkhozniki* in the Soviet Union, private farmers in Poland, private small scale entrepreneurs in the GDR. The close link between social security provisions and the worker status derives from the first and foremost property of the socialist welfare state - full employment. The full employment guarantee was made possible by the specific role of the firm in the socialist system, not being primarily an economic unit, but a social one. Without any competitive pressure and with a state guarantee of existence, the state-owned enterprise could provide any wished-for employment and take over many tasks of the social security system. Since, as a rule, these firms were big, they had a regional function and could adopt local administrative tasks which otherwise would rest with the local communal or provincial administration. A second social security short-cut was the practice of price subsidies which, by the way, makes the calculation of the size of the socialist welfare state so cumbersome. By fixing only symbolic prices for the necessities of daily life, food, clothing, housing, public transport, the socialist welfare state was convinced to have solved the problem of poverty and did not need any carefully designed targeted measures.

Technically, the formerly independent social insurances - in ECE more or less closely following the Bismarckian model - were incorporated in the state budget and state administration. The firms were paying the workers' contributions into the budget and they, or more precisely the enterprise organisation of the trade union, were administering the claims of their workers. Pensions were rather small, thus inducing an additional labour supply, and they had the special problem of hidden inflation: the older a pension claim, the smaller its real value. Health care was directly provided by the state. A statistically comprehensive provision suffered from low quality and underfinancing which led to the wide-spread practice of side-payments by the clients in order to get proper and timely treatment. Education was the pride of communism. In short, economics and politics and, in our case, economic policy and social policy were not separated from each other. The workers stood under the protective guarantee of a paternalistic state. They were free of any responsibility, life was organised in all its aspects - the nightmare of any liberal critic of the welfare state.

Obviously, this system could not be carried on once transformation from socialist planning to capitalist markets had come on the agenda. Nevertheless it is common knowledge that transformation of the social security system was not among the priority objectives of reform policy and could be treated as second order phenomenon (Ringold 1999, Wagener 1999b). This needs a brief explanation. Indeed, the transformation programs preferentially aimed at stabilisation, liberalisation, privatisation, and when the objective "institution building" was made concrete, it was the introduction of a functioning banking system and capital markets that got pride of place. Implicitly it was thought that the new economic regime had inherited an operating social security system from the old regime about which it could care when the priority objectives had been dealt with. Typically, Leszek Balcerowicz's (1995) account of the Polish transformation process does not mention the terms social security and welfare in its index nor do they show up in the text. In the early 1990s they were not important, although, especially in Poland, they became so very soon. As a matter of fact, stabilisation, liberalisation, and privatisation changed thoroughly the inherited social security system. For all this was about the separation of economy and polity assigning a completely new and purely economic role to the firm.

Liberalisation had two effects. It separated the firm from the state and made it an independent economic unit with (more or less) hard budget constraints. In order to survive in the market, firms, even if they still were state-owned, had to cut all costs which were not necessary with respect to commercial production. Overstaffing was reduced immediately and unnecessary social provisions were relinquished. Transition to the new system may have been eased by some budget subsidies or soft bank credits, especially for big old firms. But stabilisation puts limits to such softening measures, since they inevitably have inflationary consequences. As a result, unemployment was unavoidable and unemployment benefits became an immediate necessity. At the same time, the decline of formal sector employment reduced the revenues of the social security system. This decline was not uniform all over the region. While in the Czech Republic the lowest level (1989 = 100) was reached at 89.7, in Hungary the corresponding figure was 69.8 (UN-ECE 2000: 228). It is easy to imagine that the strain on the welfare state was much more serious in Hungary than in the Czech Republic. Further, certain social services, up to then provided by the firm, either got outsourced or disappeared altogether. Effective privatisation reinforced this tendency. The second effect of liberalisation was the freeing of prices which, together with stabilisation, also meant the discontinuation of price subsidies for life's necessities. Where nominal wages or transfer payments were inflexible, real incomes must have dropped, occasionally under the poverty line. At the same time, the pension, health and education systems could be continued for the time being in a more or less unreformed way transferring only the administrative tasks from the firm to the state which did not have the appropriate administration to start with. Social policy, above all the pension system, has been used in the first phase of transformation to cushion or to compensate for the immediate social consequences of the transition crisis (see Offe 1993). The crisis being an unexpected phenomenon, governments may have worked under the assumption that the rather rapidly increasing costs of such measures to the social security system would be of a transitory nature. Only when and where it turned out that this is not the case, fiscal problems moved social policy centre stage. So we conclude that unemployment benefits, social compensation, and the technical administration of welfare benefits were of first phase transformation concern, while the basic models got on the agenda not before the second phase.

3. Transformation of the Welfare State

Transformation of the welfare state has an important preliminary stage: transformation of the state. This is by no means a trivial affair. The old communist state crumbled throughout the region. Transformation of the political, economic, and social systems could only be accomplished under the guidance of a strong state. The solution of this conundrum was at the roots of transformation success. Successful transformers, after the inevitable transitional crisis, resumed economic growth and accomplished in-depth structural changes. These countries have comparatively well established democracies and effective governments; they are typically to be found in Eastern Central Europe. Less successful transformers did not overcome the initial crisis and slid into a protracted depression. In these countries state governance is weak, very often captured by particular interests, and unable to perform its normal functions; they are typically to be found in the Former Soviet Union, Russia and the Ukraine being the most spectacular cases. As a result these countries are situated in a kind of limbo: the state is weak and poor and cannot live up to the expectations of the population. Compensatory social policy as reaction to the transition crisis is out of question. The firms, albeit privatised, are not thoroughly restructured and operate in what has been called a "virtual economy" (Gaddy and Ickes 1998). Workers are staying with their old firm even if they do not get payed, since certain welfare provisions, housing for instance, are still offered. For the rest, the citizens have to look after themselves which means that large strata fall into poverty. It is typical for the FSU countries that poverty has increased significantly during the 1990s, while in ECE this happened only moderately: the incidence of poverty increased between the periods 1987-8 and 1993-5 in Hungary from 1 to 7 per cent of the population, in Poland from 6 to 10 per cent, in Estonia from 1 to 34 per cent, in Romania 6 to 48 per cent, and in Russia 2 to 39 per cent (Milanovic 1998: 77; the figures may be disputed, the trend is unquestionable). The inequality measures show similar developments (ibid.: 41). This is not the place to speculate about why state transformation succeeded in ECE rather than in the FSU. Many factors may have played a role (see Wagener 2001) among which geographical, historical, and institutional proximity to the European Union, or the West in general, figure prominently. The expectation to become member of the EU in due time served as a transformation anchor for the political, the economic, as well as the social security system.

With respect to many institutional aspects envisaged accession to the Union predetermined the choices of the transformation countries in ECE, not so with respect to the welfare system. However, econometric research has shown that a dummy variable "Europe" is positively correlated with the share of government expenditure in GNP (Barbone and Polackova 1996; Fakin and Crombrugghe 1997) reflecting a particular European welfare culture. Indeed, there is a general commitment of the EU to social security, but the "responsibility for organizing and financing of social protection systems is in the hands of Member States" (Commission 1999). This statement refers to the great variety of welfare systems within the Union and their deep political-historical entrenchment which makes even marginal reforms a very difficult and often impossible endeavour. For the transformation countries it implies that they may choose between different models of welfare systems. Liberal reform advisers are warning against restricting the choice to European models only disregarding

East-Asian experiences: high government, in particular high welfare, expenditures are considered a threat to economic growth (Sachs 1996). When social expenditure is disentangled from capital expenditure and government consumption, however, only the latter can be connected with negative growth effects while the two former improve the growth prospects (Easterly and Rebelo 1993). Nor does the growth record of the successful transformation countries in ECE, which have rather developed "European" welfare systems, corroborate the hypothesis.

It has become customary to distinguish with Esping-Andersen (1990) three worlds of capitalist welfare systems the criteria being the commodity character of labour, the matrix of social equity (stratification vs. equalisation), and the public-private welfare mix:

- the liberal model which tries to avoid poverty by a minimal safety net and leaves the rest to private responsibility and initiative - the prominent example are the US with a share of public social security and health expenditures in GDP of 14.6 per cent in 1990,
- the conservative-corporatist model which adheres to the contribution-related benefit criterion of mandatory insurance-type regimes and subsidiarity between family, firm, and the state - Germany's Rhenanian model is a typical example: public social security and health measures took 23.5 per cent of GDP in 1990,
- the social-democratic welfare state which guarantees social citizenship rights and adheres to the redistributive ability-to-pay criterion - Sweden is the best known example with 33.1 per cent of her GDP devoted in 1990 to public social security and health expenditures (Esping-Andersen 1996: 11).

As always with ideal-type distinctions, borderlines between systems are more fuzzy in reality. But the size of the three mentioned welfare states testifies to significant differences.

It was generally expected that the transformation countries in ECE, at least their political parties with leftist inclinations, would be attracted by the Scandinavian model of the welfare state. On the other hand, liberal reformers and some of their western advisers were enchanted by Margret Thatcher's, or her favourite social philosopher Friedrich von Hayek's, anti-welfare state rhetoric. Vaclav Klaus' dictum of a market economy without adjectives, in particular the adjective "social", became notorious. Not without surprise it was found that neither the one nor the other could be traced back in the political practice of the transformation countries. The liberal rhetoric has not led to uncompromising liberal models, even not in the Czech Republic although this is sometimes claimed (Götting 1998: 170) - the difference between rhetoric and practice has been dubbed the "Klaus-paradox" and adequately explained as a political compromise by Müller (1999: 137-9). Nor did the enlightened left in ECE - the orthodox communist left in Russia and Czechoslovakia insisted on the old socialist model - propagate the social-democratic welfare state model. It seemed too close to the old model, it was unsustainable in the economic situation of the transition countries, it did not conform to the market system which was the primary objective of transformation, and it seemed to be in a crisis in its countries of origin - such were some of the objections in the region (see Gedeon 1995, Götting 1998: 84-8, Cook, Orenstein, Rueschemeyer 1999). So what was then the guiding line? "Add Beveridge-style minimums to a fundamentally social insurance-based welfare system, and you have the social market model pushed by the left in contemporary post communist Europe" (Cook, Orenstein, Rueschemeyer 1999: 343). With a somewhat stronger emphasis upon the state welfare system, such was also the result of the first transformation phase. It is a clear result of path dependency: the Bismarckian social insurance model was predominant in the region before the communist take-over, and the state welfare system is characteristic of the communist system, as we saw.

The first step in welfare system transformation was a partial return to the pre-war regime: a re-institution of the Bismarckian social insurance which formally, but not materially, had survived in some countries under the communist regime. Such reforms were distributed over the whole ten year period of the 1990s: Hungary and Czechoslovakia, for instance, re-introduced health insurance funds at the beginning of the decennium, in Poland a similar reform became effective as of January 1, 1999. The Bismarckian model is less redistribution and more contribution related, while the public still expected a broad protection against risks, an expectation which was honoured by writing basic social rights into the new constitutions. This was a major achievement compared to the communist regime: linking the welfare state with the rule of law and giving thus the constitutional courts a say in social policy. Of course, the adapted system came quite close to the continental conservative-corporatist model. It may be questioned whether the choice was made deliberately to accommodate the median voter (ibid.) or whether it was the rather *ad hoc* and often contradictory result of some fiscal specialists' efforts to keep the social security system going under the new conditions (Ringold 1999).

Most countries formally succeeded in separating the social security funds from the state budget proper, not necessarily with an own legal status and self-administration, and separating the pension funds from health care insurance. Yet the weak level of contributions due to unemployment, shadow activities, and non-compliance, could not come up for the increased expenditures and constituted a considerable burden to the state budget which had to cover the deficit by subsidies. If not the communist welfare state was premature living above its means, the post-communist welfare state certainly was. In Poland, the most extreme case, the share of social expenditure in GDP increased from 17 per cent in 1989 to 32 per cent in 1995. Less dramatic increases happened in the Czech Republic, Hungary, and Slovenia (ibid.: 30). These increases are mainly due to unemployment and pension benefits. The share of the latter in GDP increased in the indicated period in Poland from 6.6. to 14.6 per cent, in the Czech Republic from 8.3 to 9.1 per cent, and in Hungary from 9.1 to 10.6 per cent (Schrooten, Smeeding, Wagner 1999: 282). The reasons for such a short term rise were of course not demographic, but policy related. The shares of health and education increased between 1990 and 1993 in Hungary and the Czech Republic and then diminished in the first and stabilised in the second country. In Poland it remained more or less constant on a somewhat lower level (EBRD 1999; most other transformation countries do not show relevant data). According to another estimate (Mihályi, Petru 1999: 28), the share of health care expenditure in GNP went up by almost 3 percentage points in the Czech Republic after 1992, while in Hungary it decreased by 2 1/2 percentage points. In both these countries this share was significantly higher than in Poland where the old tax financed and state run health care system remained in force till the end of 1998. Needless to stress that the situation in FSU countries, notably Russia, the Ukraine, and Moldova, was completely different.

It would be wrong to state that the health and education systems remained more or less unaltered meaning poor in general. The Czech Republic, Hungary, Slovenia, and recently Poland introduced mandatory health insurance systems and started to decentralise and partly privatise provision of health services which, however, is still predominantly a state or communal affair. But the quality of services, here as in education, depends on capital and labour. The former is urgently needed for a thorough re-equipment, the latter was notoriously underpaid under the old system. Given the fact that the share of health care expenditure in GNP is with slightly above 8 per cent in Hungary and the Czech Republic (Mihályi, Petru 1999) on a Western level, the problem appears to be less one of additional means than of a fundamental restructuring of the sector. In Poland the system seems to be underfinanced, as stated. Again we notice a huge difference in the health status of the population between the FSU, where the state literally collapsed, and ECE where the situation did not improve significantly, but was more or less stabilised (Goldstein 1996). One reaction to this state of affairs is a creeping privatisation and commercialisation of health services: the more deficient the services, the sooner the general public, or those strata who can afford it, is willing to finance privately proper treatment. This happens from Poland to Bulgaria and, naturally, in Russia. The mounting costs of the pension schemes in ECE are due to different reasons among which hidden unemployment, indexing (to rising prices, not to falling real wages), and policy pressures are prominent. The differences within the region are considerable. So the relative income position of pensioners during the period 1987-8 and 1992-3 improved in Poland and Slovenia, it remained more or less unchanged in Hungary, Slovakia, and Romania, and it deteriorated in the Baltics, Bulgaria, and the Czech Republic (Götting 1998: 178).The problem of ageing could have no impact in so short a period, but will, of course, make itself felt in the future. In short: there are several motives, mainly fiscal and systemic, not to go on muddling through, but to enter the second phase of transformation by reforming the welfare state starting with the pension system.

4. Second Phase Reforms of the Pension System

Fiscal and systemic problems with the welfare state, especially in the context of an ageing society, is nothing unique to ECE. Similar questions are a hot issue also in the member states of the EU and elsewhere. The naive outside observer would presume that, given the stage of development and of political and social culture of the Union, the member states have found solutions that are superior to the received Anglo-American, continental, or Scandinavian models and that could be imitated by the young democratic market economies in the East. Nothing could be more erroneous. The received welfare state systems of the West exhibit a remarkable tenacity which may be due to the fact that they are the result of a long and fierce social struggle in the past and that the present political systems which have to agree about reforms are highly complex and delicately equilibrated matrices of interests - less friendly critics speak of Euro-sclerosis - to the effect that changes happen, as a rule, in the margin, but that radical system transformations are rather hard to achieve. The Union itself has very little competence and leverage to develop and impose own ideas about social security, as mentioned already. The Treaty of Amsterdam (art. 136 and 137) makes it very clear that national preferences are to be observed and that each member has a right of veto in this field.

The situation is quite different in the so-called emerging markets to which belong also the transition countries. And there is an international institution with outspoken ideas about the welfare system and with considerable leverage to make itself heard in these countries, the World Bank. The characteristics of the pension system favoured in the environment of the World Bank (World Bank 1994) follow from the so-called Washington consensus (Williamson 1990) which is based upon fiscal stabilisation, regulative liberalisation, and organisational privatisation - the very objectives of transformation in ECE. It should be mentioned that the Washington consensus does not contain recommendations with respect to social security, either because there was no consensus about it or because it was considered of secondary importance at the time. Nevertheless fiscal stabilisation, regulative liberalisation, and organisational privatisation are clearly the theoretical basis of World Bank institutional policy recommendations. For the pension system this implies a three-pillar model (see Müller 1999: 27) with a minimal poverty-targeted first pillar on a pay-as-you-go (PAYG) basis, a mandatory private insurance second pillar on a fully funded (FF) basis, and a voluntary private insurance third pillar. The difference with the prevailing European systems is to be seen in the shift from the first to the second pillar - privatisation and an individually contribution related scheme where the arrangement can be personal or occupational. Upon closer inspection we see that the stress is lying on privatisation. For the venerable Bismarckian model (which seems never to have been fully understood by the Washington advisers who confound it with the Beveridgian welfare state) was, if not perfectly, individually contribution related and it was fully funded. However two spells of high inflation in 20th century Germany have diluted the funds (and shown the dangers of such a system if it is not backed-up by the state) so that it could not be practised while still formally in force (up to 1957). The objective of the World Bank model is not only old age income security, but enhanced economic growth (see its subtitle "Policies to Protect the Old and Promote Growth", World Bank 1994). It is assumed that funded systems will produce a higher savings rate than PAYG-schemes and that funds accumulated in private insurance companies will play a more active role in the capital market than funds accumulated in a public pension system. From this follow the logic and the dilemma of the model: emerging markets need capital for growth, but their capital markets, and their financial stability in general, are poorly developed and very sensitive. However, the idea of combining old age security and increased capital accumulation must be attractive in the transition countries that are eager to catch up with the European Union.

A radical implementation of this "new pension orthodoxy" (Müller 1999: 29, the term originally derives from Lo Vuolo 1996), as it happened 1981 in Pinochet's Chile, would imply almost a return to the pre-welfare-state world with individual responsibility and poor laws were it not for the mandatory character of the private insurance. It would not correspond with the, at least in Europe, evolved idea that exactly in the context of long term welfare protection individual decision making and the market need some subsidiary state support, nor with the European social security culture containing a strong element of solidarity, nor can it be taken for sure that a system relying almost exclusively upon the capital market is able to provide the hoped for long term income security. On the other hand, a reconsideration of the public-private mix is deemed necessary in many countries and "three-pillar" models are discussed and adopted all over the world. It was particularly Argentina which succeeded in 1994 to transform its state-dominated pension system by a democratic decision process into a complementary public-private system. This is not the place to analyse the merits and demerits of PAYG and FF systems, of their possible combinations, and of their introduction or reform. Suffice it to say that also the EU-Commission (1999b: 13) is recommending an "appropriate balance between funded and PAYG (pay-as-you-go) systems". The Commission is motivated in this by its concern for macro-stability withing the EMU and for more employment-friendly flexibility in the labour market. Both these motives must play a decisive role in Eastern European pension reform considerations.

The first phase pension system reforms in ECE had achieved a certain formal, although not financial, separation of pension schemes from the state budget (with the exception of the Czech Republic whose pension system was in surplus which was gladly used by the state budget), the (re-)introduction of employee contributions, some kind of indexation arrangements, and some basic parameter changes (replacement rates, e.g.). The second phase pension system reforms can be grouped in three clusters (for the following see Müller 2000):

- Parametric changes of the existing PAYG-system.
- Notional defined contribution schemes.
- Mandatory fully funded schemes.

Parametric changes of a PAYG-system can imply very different things. In most parts of Western Europe it means, up to now, a tinkering with replacement rates, the pension formula, or the retirement age. All this is done in ECE too. But when the change implies a switch from a Beveridge-type tax-financed general fixed pension to a Bismarck-type contribution-financed and contribution related pension, we may speak of a more radical change. The problems of such a transition are financial. For the first scheme was strongly redistributive, while the latter is meant to be less so. However, if the flat rate pension was close to the subsistence minimum, which as a rule it was in the whole region, a contribution related differentiation of retirement benefits requires additional funds.

Notional defined contribution (NDC) schemes are, in fact, a radical paradigm shift within the public pensions system that loses by this change much of its PAYG character. The basic idea is rather simple: each employee has an own capital account with the public social security system where the contribution on her behalf, be they employers' or employees' or other contributions, are registered. Let well, these individual capital accounts are notional, no real funded accumulation takes place. At the end of the working career, the accumulated notional capital together with the statistical life expectancy define the actuarially fair pension benefits. The system has several advantages: it is contribution related, its claims can be carried with over state borders by employees, and the risk of demographic changes is not laid down with the paying, but with the receiving generation (in the present situation of ageing many people consider it an advantage). This innovation was developed by Swedish pension specialists and pioneered with the help of Swedish advisers in Latvia in 1996, before it also became a core element of the Swedish pension system reform passed by parliament in 1998 that up to now is the only far-reaching reform within EU member states. The new Swedish system can be called a four-pillar-system with a tax-financed (and means tested) minimum pension, a public tier along the lines of the NDC principle, a mandatory private FF tier, and voluntary private provisions. Although this model may gain paradigmatic character in the future, its introduction was greatly helped by special Swedish circumstances that will not prevail everywhere. By considering the introduction of a mandatory private FF tier, the present German government is also heading for a four-pillar-system: poverty relief by social assistance is a communal responsibility, the core institution is a public PAYG insurance scheme that is meant to be supplemented by a mandatory private FF tier, and the system is rounded off by voluntary private provisions.

The introduction of mandatory fully funded schemes in Eastern Europe is a very special case of institutional transfer. For unlike many other instances where the *acquis communautaire* has shaped the paradigm for transformation targets, in this case the transfer happens from Latin America to Eastern Europe not without, it has to be mentioned, intermediation and support of the World Bank. As said, there is no *acquis communautaire* with respect to pension schemes in the EU and the member states are themselves confronted with the task to reform their old age provisions due to demographic, fiscal, and market related reasons. It turns out, contrary to received opinions in political science (Bönker 2001), that compared to old democracies in Western Europe the new democracies in Latin America and Eastern Europe encounter less resistance from entrenched interests when deciding and implementing radical reforms. Of course, the Danish population, for instance, which enjoys the most comprehensive tax financed public pension scheme, lives under the impression that they have a lot to lose in any reform and so will resist it. Resistance to reform is moderate in ECE (see Greskovits 1998, according to whom this may be due to precisely the existing welfare state) and does not impede some radical changes which may still be associated with the general expectation of the "period of extraordinary politics" (Balcerowicz) that there is a lot to be gained by transformation.

The most radical reform in transition countries has been introduced 1998 in Kazakhstan following the Chilean precedent. We will leave the whole CIS region aside here. It is full of problems of its own not the least being serious payment arrears and, consequently, wide-spread poverty among the aged. Such problems are not solved by radical privatisation. Of more interest are the Hungarian and Polish reforms which implemented truly "multi-pillar models" combining a PAYG tier with a mandatory fully funded insurance. The Hungarian reform went into force in 1998. Actually it yields a four pillar system which, as we see, seems to become the rule in Europe. It supplements the dominant and still to be reformed public PAYG-system with a mandatory private insurance tier. At the low end there is a means tested minimum pension, and at the high end a voluntary "third" pillar. The difference between mandatory private pension funds and voluntary insurance contracts can be seen, here as elsewhere, in the scope of prudent regulation. Of course, the whole financial sector of banks and insurance companies is carefully regulated and supervised by the state in well functioning market economies. Legislating mandatory private pension funds gives the state a special responsibility to guarantee solvability and liquidity which it will fulfil by additional prudent regulation. Here we can establish one of the core features of welfare state privatisation: the state partly retreats from own provisions transferring the production of services to competing private enterprises which are, however, carefully regulated and controlled to protect their clients. For the risks of the market and of market failure (bankruptcy, adverse selection, moral hazard, the latter two playing an even more important role in health insurance) cannot be borne by the individual citizen. Elements of redistributive solidarity which are implicitly present in welfare state arrangements will only in exceptional cases be taken over by the private providers. They will have to be made explicit and organised in targeted state measures.

In Poland the new system came into force in 1999. The first public tier underwent in itself a thorough reform: its organisation, the ZUS which also covers disability, sickness, and accident risks, was separated from the state and got an own legal status, it is financed by employers' and employees' contributions, and it pays benefits according to the notional defined contribution principle. It is supplemented by a minimum pension which may be seen as pillar of its own in order to avoid poverty among the aged. The second pillar is a mandatory fully funded tier managed by strictly regulated private pension funds. It is financed only by employee's contributions and, naturally, disburses contribution defined benefits. The third pillar, as everywhere, are voluntary individual old age provisions. Contrary to the Argentine model, membership of the second tier is not optional in Poland (except for the transitory period and people of intermediate age). In the final state, each employee will pay contributions into and obtain benefits from both sources. According to present legislation, the first public PAYG-tier is dominant. Indeed, resemblance with the Swedish reform cannot be overlooked and Swedish advisers were active in the country.

The transition to a new pension system is a lengthy and costly affair, since notional as well as real funds have to be accumulated and benefits must be paid in the meantime. So it is not to be expected that the state budget will encounter any appreciable relief of the welfare state expenses in the short run. In addition, transitory arrangements, the details of which we have omitted in this brief overview, will be and, in the countries that took already the reform steps, are rather complicated and difficult to grasp for the general public. Secondly, these reforms put a heavy burden on the administration: administering those transitory arrangements, administering NDC accounts, and implementing prudent regulation require experienced personal and expensive equipment. Thirdly, private pension funds will flourish only in the environment of strong and stable capital markets. It remains to be seen how Hungary and Poland, and their followers Bulgaria, Latvia, Croatia, and Macedonia, will get along with these problems. It is not purely imaginary to fear that Kornai's dictum of a premature welfare state in the end comes true in a premature radical welfare state reform.

5. Welfare State Accession Problems?

Since in the field of social protection the Union has not developed a voluminous *acquis*, the starting hypothesis will be that there are little problems in this respect for the ECE countries to become member. Just to follow the previous paragraph, any type of pension scheme ought to be acceptable for the EU in view of the differences between the new Swedish, the Danish, the German, or the British systems. Of course, the Commission must be concerned about the free movement of capital, labour, and services within the single market. An here the diversity of pension systems, as well as health care systems, forms a major impediment to labour mobility. Clearly, non-harmonised regulations of state organised PAYG pensions schemes and of public as well as private health care provisions make it unattractive for labour to move freely between member states. A second concern of the Commission is fiscal stability and with it the stability of EMU. Intergenerational solidarity in PAYG systems draws a cheque on the future which may become expensive when demographic parameters are changing as they are right now for most European countries. The temptation must be great for governments to postpone part of the additional burden to a more distant future by issuing bonds. In that case member states with smaller such liabilities, like the UK, will have to share in the consequences of cet.par. increasing capital costs (Ross 1999). All these are general problems, nothing specific to the new candidate members.

We have seen that fiscal crisis has induced several of the transformation countries in ECE to engage in radical welfare state reforms. In that they are ahead of many incumbent member state that complains about the heavy burden of ageing and rising health care costs. Solutions have to be national and may follow different welfare state paradigms. It is, however, intriguing to consider that particular radically reformed welfare state regimes will gain a certain weight after Eastern enlargement within the Union influencing the institutional policy choice of reform late comers. As far as third pillar private social insurances are concerned, which in the form of occupational welfare provisions play an important role in many Western countries, the Union endeavours to become more active to accomplish the single market in the field of services (Commission 1999a). But also in this case national sovereignty is involved very soon. The points of concern are prudential rules for supplementary pensions schemes, coordination of tax systems, and the influence on social partners to negotiate schemes that do not inhibit labour mobility. Occupational schemes play a minor role in ECE, partly due to the traditional overall state responsibility for social security, partly due to the low degree of organisation of social partners after the switch to the market order.

There could be seen an accession problem, and in some member countries it is seen as a veritable menace, in the fact that all membership candidates are poorer, in the majority of cases considerably poorer, than the least developed country of the EU-15. The expected consequence is migration from the poor to the rich countries. As far as such migration is wage induced, there is little wrong with it from an economic point of view. However, if migration is induced by differences in welfare provisions, things become more difficult. Differences that are linked to labour contribution and income, as in contribution related private insurance schemes, again pose little problem from an economic point of view, although the possibility of moral hazard in health care insurance cannot be excluded. As soon as welfare systems with strong redistributive elements are concerned, it depends very much of the concrete arrangement whether the resulting migration implies an inefficient allocation of labour or not. Reforms introducing NDC and FF schemes go into the right direction, but also the existing systems can cope with the problem.

Two popular catch words in this context are "welfare state tourism" and "social dumping". Both are suggestive and essentially wrong in their implications. For the freedom of labour mobility relates to the employed and not to the unemployed. The employed, however, will gain with their labour contribution claims that are not only paid out as take-home wage, but also in the form of social security benefits. These claims are backed-up by the workers' productivity which is higher in capital intensive high developed countries than in labour intensive less developed countries. The term social dumping implies a deliberately low social security standard in order to gain a competitive edge. As long as the labour market is not completely rigid, lower non-wage labour costs will be compensated by higher wage labour costs. The distribution of firm labour costs between the two may be a parameter of economic policy, total labour cost is not. Interestingly, the reproach of social dumping is always directed towards low labour cost countries, not high wage countries like the US or Japan which have significantly less developed welfare states than Europe. They are rather used as paragons of "reasonable" welfare state regimes by liberal critics of the European paradigm. Within the EU there is a particular practice that may be subsumed under social dumping, namely importing workers from low wage member states (which, under normal conditions as just stated, must be due to lower productivity and not to lower social security contributions) and paying them partly or fully in their home countries. Trade unions consider it as unfair competition. After the accession of extremely low wage countries, such practices may become an even more serious problem. Clearly, harmonisation of social security payments would not solve it.

We come to the conclusion that the divergence of social security arrangements within the Union may have negative effects upon the mobility of labour. This state of affairs will not be significantly deteriorated when new members from ECE join the club. The enormous difference in total per capita welfare between the Union average, and even the least developed incumbent member states, and the accession candidates poses serious problems and strains on their neighbouring countries and on the Union budget. The following statement, however, seems unwarranted to me: "The European Union therefore faces a challenging task to harmonize its differing social security systems before it expands eastward" (Schneider 1999: 142). Ironically, it has been made by a Czech scholar. If taken seriously, it would postpone the enlargement for an indefinite period.

6. Conclusions

Capitalism is all about efficiency, communism was all about distribution. If this were right, transformation would be about getting from the welfare state to the nightwatchman state. And observers of the social consequences of transformation were justified in ascribing the undeniable deterioration of the social situation in Eastern Europe to the transition from one evil to another. Yet things are a bit more complicated. The liberal policies of stabilisation, liberalisation, and privatisation that are indispensable in order to introduce a market order do not imply the neo-liberal spectre of an overall abolition of the welfare state. No such thing happened in the region. What happened in part of the region was state collapse. And therefore one has to differentiate carefully between ECE and the FSU. All the horror stories about transformation induced excessive alcoholism, falling life expectancy, deteriorating health status, appalling income inequalities are true for the CIS region, in particular Russia, the Ukraine and Moldova, but much less so for ECE. The Balkans and the

Baltics have been hit more by such evils than the four Visegrad countries and Slovenia (and also Croatia). That is, those countries where transformation was carried out swiftly and with determination witnessed the strongest economic upturn and had to suffer least from the social consequences. And only these countries will be able to fulfil the accession conditions of the EU.

Taken literally, the communist welfare state is a *contradictio in terminis* since there was no autonomous economic system whose way of functioning and results would have to be altered, complemented, or supported by the use of political power. Under communism political power is all-pervasive: Lenin's primacy of politics. The re-introduction of the market fundamentally changed the role of the firm and this implied a concomitant change of the social security system. The latter change, in fact, did not keep pace with the former and thus caused the immediate deterioration of the social situation. The first phase of welfare state reform can be described as a kind of muddling through trying to avoid the worst and to adapt the institutions that were inherited from the past to the immediate requirements of transformation. In many cases this kind of muddling through ran into fiscal problems and induced the second phase of welfare state reform.

Health care and education pose even more intricate problems than old age, invalidity, and unemployment income security. For there is not only a necessity to re-organise the financial provisions of these systems reconsidering also here the public-private mix. But being sectors of production, their achievements depend on capital equipment and labour resources. The latter have been inherited in ample quantity from the old system making restructuring a necessity. The legacies with respect to the former are rather poor. So the improvement of both sectors will be achieved only over a longer and costly investment period. Expenses for health care and education in the ten accession candidates in ECE as share of GNP are only about 10 per cent lower than in the EU-15 on average (EBRD 1999) which, given the fact that GNP (at purchasing power parities) is on average only 40 per cent of the EU average, implies of course a considerable lower absolute level that is, however, partly compensated by the lower labour costs.

Only when the new economic order was more or less established, some countries entered a second phase of welfare state transformation in which more consistent models were developed. The political economy of this process is interesting in itself (see Müller 1999).The willingness to reform, stronger for instance in Poland and Hungary than in the Czech Republic, can be explained by a welfare state crisis and, above all, by a fiscal crisis thus reducing the possible influence of different shared ideas about social security. Political legacies from the communist and the pre-communist period constrain the extent of reform and determine its direction. Having been part of the European welfare state tradition, in particular its Central European variant, these countries were not prepared to take over the World Bank model without alteration. The public-private mix of the new pension models in ECE and, as we saw, also in Sweden (Germany has a similar reform in the making) differs significantly from the World Bank advice in whose three-pillar model the brunt of social security costs is borne by the private second pillar, the public first pillar providing only for poor relief. The new European four-pillar model uses the mandatory fully funded private pillar as a complement, not a substitute for public social security. So it will in the end be the state, as legislator, regulator, and organiser, who remains responsible for the quality and legitimacy of welfare state transformation: "state capacity is probably the single greatest determinant of the ability to create and manage a welfare state" (Orenstein 1999: 10). And good governance is the single greatest problem of the transformation countries in Eastern Europe.

Hans-Jürgen Wagener
Frankfurt Institute for Transformation Studies
European University Viadrina Frankfurt (Oder)

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